

Investing Basics

Once you're out on your own and have implemented your spending plan, built your emergency fund, and protected against financial loss with appropriate insurance, it's time to move from saving to investing. Investing not only helps you make more money, it keeps you from actually losing money. How? Inflation and taxes reduce the value of money over time. So while money in a savings account may preserve your purchasing power, it doesn't really grow.

A Checklist for Smart Investing

- ❖ **Investing is for the long-term.** The key to making the most of your money is to invest small amounts gradually and sensibly over time. Think in terms of at least five to ten years down the line or longer. Investing is different from short-term saving for the down payment on a car—you need time to ride out the inevitable ups and downs of the market.
- ❖ **Learn the basics of investing and keep it simple.** Don't invest in anything you don't understand. Leave complex and high-risk investments, such as options, futures, commodities, penny stocks, and limited partnerships, to the pros.
- ❖ **Have patience.** Have realistic expectations, use common sense, and don't expect to get rich quick.
- ❖ **Don't put all your eggs in one basket.** To reduce risk, diversify and practice asset allocation. This means dividing your money among different types of investments according to your needs, to help protect against loss and increase your chances for making money. Diversifying works because different types of investments tend to move in different cycles—some may go up while others go down. Others may move in the same direction, but not at the same time or speed.

Investments at a Glance

Bonds: When you buy a bond, you're lending money to a corporation, an institution, or the government. In exchange for the use of your money, you earn interest and the promise that you'll get back your principal (the money you invested) on a set date.

Bonds are issued to raise money for things like schools, highways, bridges, and factories. Bonds have different face values, interest rates, and maturities (the length of time until the bond becomes due), and levels of risk. For example, bonds issued by the U.S. Treasury are considered completely safe because they're backed by the full faith and credit of the U.S. government. On the other hand, bonds with low or no credit ratings, called junk bonds, are considered high risk. If you need to sell a bond before it's due, you could get more or less than what you paid for it, depending on market conditions at the time. Bond values increase when interest rates fall, and decrease when rates rise.

U.S. Government Series EE Savings Bonds are issued by the U.S. Treasury Department and are considered one of the safest investments around because they're backed by the U.S. government. However, EEs work differently than other types of bonds—their face values don't vary according to market conditions, so they're never worth less than you paid for them.

Here's how EE Bonds work: Let's say you buy a bond that has a face value of \$50.00. You'll only pay \$25 since the bonds sell at one-half their face value. You redeem them for full face value at maturity. You can cash them in anytime after six months, but the longer you hold them, the more money you'll make. When you hold the bond for five years or longer, you'll earn either a guaranteed minimum interest rate, or a variable rate that fluctuates with the market, whichever is higher. Series EE bonds also offer tax breaks: You don't ever have to pay state or local taxes on the interest the bonds earn, and you don't owe federal tax on the interest until you cash in the bonds.

Stocks: When you buy shares of common stock, you become part-owner of a corporation along with other people and institutions, commonly numbering in the thousands. As a stockholder, you can make money in two ways: First, the company may pay dividends, which are your small share of the company's profits. Second, if the price of the stock goes up, you can sell your shares for more than you paid. Conversely, if the price of the stock declines, you risk losing money.

With tens of thousands of companies to invest in, each with a different level of risk, stock selection is a serious business. To successfully invest in individual stocks, you should have enough money to diversify your holdings, along with the desire and time to do the necessary investment research and analysis. Because many people are not so inclined, investing in stock mutual funds is a popular alternative.

Stock or bond mutual funds offer investors instant diversification and professional money management. When you invest in a mutual fund, your money is pooled with the money of thousands of other people. This allows fund managers to buy a wider variety of investments than most people could buy on their own. As a shareholder you share in the fund's gains, as well as its losses.

There are thousands of mutual funds to choose from, each with different goals, risks, and returns. The most common type are open-end funds that sell unlimited numbers of shares to the public. You can withdraw your money from an open-end mutual fund anytime by selling back your shares. However, the amount you'll get back depends on how the fund's investments are doing at the time. Although investing in mutual funds may seem easier than buying individual stocks and bonds, you still have to do your homework and choose funds carefully.

Automatic investment plans regularly transfer a designated amount of money from your checking account to your mutual fund. This also allows

you to take advantage of what's called "dollar cost averaging." Instead of trying to guess the best times to invest, your money buys fewer shares when prices rise, and more shares when prices go down. Over the long run, your average cost per share is lower and you're likely to make more money. When you sign up for an automatic investment plan, some funds will waive or reduce the minimum initial investment requirement, so you can get started investing sooner.

It Pays to Start Investing Early

Investing small amounts each month may not seem like a lot, but if you start socking it away when you're in your twenties, it'll translate into big dollars down the road. The reason: Your earnings have time to compound over the years.

For example, let's say you invest \$2,000 a year starting at age 25 in a tax-deferred account that earns a 10% average annual return. At age 65, you'll have accumulated a total of \$885,000. Compare this to if you had waited to begin saving until age 35: Your nest egg would total only \$329,000. That \$20,000 you didn't save between the ages of 25 and 35 ends up costing you \$556,000!

Stock Investing Pays Off

Investing in stocks or stock mutual funds offers a way for your money to grow over the long-term, even after inflation and taxes. Although the stock market can be volatile in the short-term, over the long-run inflation is a bigger problem. Consider this: Over the past 67 years, stocks have consistently outperformed the rate of inflation and other investments, returning a pretax average of about 10% a year. What about the odds of losing money? The longer you hold stock, the safer you are. In fact, since 1926, the odds of losing money in the stock market over 10-year periods was just 4%. In contrast, the odds over a one-year period was a much riskier 30%.



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Investing: A Review of the Basics

1. Why is investing different from saving?

2. Name two things bonds may be issued to raise money for.

1)

2)

3. Explain one way you can make money as a stockholder in a company.

4. What does it mean to diversify your investments and why is it important?

5. U.S. Government Series EE Bonds work differently from other types of bonds.
Explain the difference.

6. Explain "dollar cost averaging."